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Beneficiary and Dominant Roles in Organizations: The Case of Nonprofits

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I. Introduction.

Until recently economists have not devoted much attention to nonprofit organizations (NPOs), although they are present in almost all real economic systems and are quantitatively significant (see James, 1987, for a worldwide overview, and Rudney, 1987, for US data).

Following Hansmann's path-breaking contribution (1980), in the last few years several theoretical contributions have been presented which have attempted to identify the economic role of NPOs, as defined by a "nondistribution constraint" -- i.e. the prohibition to distribute a monetary residual to individuals who exercise control over them, such as members, officers, directors or trustees (1). (Surveys of the literature can be found in: James and Rose-Ackerman, 1986; Hansmann, 1987A; Gui, 1987; Holtmann, 1988).

In this paper, in order to clarify the specific role of NPOs, I examine and classify private organizations by focusing on the one hand on the desired pattern of surplus distribution, and on the other on the attribution of decision making power, as specified in the organization's statutes. This leads to the crucial distinction between "mutual benefit" and "public benefit" organizations, that is based on coincidence and, respectively, non coincidence between those who exert ultimate control (the "dominant" group) with the designed receivers of the organization's surplus (the "beneficiary" group). After discussing why a category should play the beneficiary role, I then investigate the reasons for adopting either the mutual benefit or the public benefit option. This theoretical framework allows for a thorough understanding of NPOs and for a comparison to be made with cooperatives and capitalist firms.

In section II I summarize three views on the specific functions of NPOs. In section III I focus on the distribution of surplus in economic organizations, of which I present a general classification based on the attribution of the dominant and the beneficiary roles. In section IV I examine the reasons for this attribution. The functions of the nondistribution constraint in public benefit and mutual benefit organizations are discussed in sections V and VI respectively, while section VII summarizes the conclusions.

II. The functions of NPOs as compared with other private organizations.

In his seminal article Hansmann presents NPOs as a "...response to a particular kind of "market failure", specifically the inability to police producers by ordinary contractual devices..." (1980, p.845). He terms this situation "contract failure" and defines it more specifically as the customers' inability to: (a) compare products and prices before buying; (b) reach a clear and detailed agreement with the supplier; (c) enforce such an agreement. However, in the following sections of the article and in subsequent works on the subject (1985A, 1985B) Hansmann seems to restrict contract failure to informational asymmetry.

When contract failure is present the nondistribution constraint, by reducing the producer's incentive to exploit its advantageous situation, would indirectly protect both customers and donors. This general claim is better assessed by looking at the various types of NPOs. Hansmann classifies them according to two criteria: i) the major source of income, whether donations or purchases; ii) the assignment of ultimate control, whether to a board of trustees or to a membership formed by those contributing to the organization's income (2). In such a way he obtains four types of NPOs, which he examines separately (see his double entry table).

Hansmann maintains that his contract failure theory does not hold with one of these types of NPOs: those selling goods and services to their own members, which he practically identifies with social clubs. These, he argues, are established to counter a different market failure, i.e. monopoly power. In fact, if the club were managed by an entrepreneur, the particular attractiveness of the club that derives from the peculiar identities of co-members would turn him into a virtual monopolist, and customer exploitation would result. Therefore, he continues, social clubs should rather be registered as cooperatives, which he sees as the appropriate organizational response to sellers' market power. The fact that in US they are registered as NPOs would be explained, instead, by tax advantages and by the absence of a particular need to distribute dividends.

Hansmann's "contract failure" theory is essentially accepted and developed by several authors; in particular Easley and O'Hara provide a formal treatment of his claims (1983, 1986). A more critical view has been taken by Ellman (1982), who proposes, instead, a theoretical distinction between "donative" and "mutual benefit" NPOs, which he sees as protecting respectively donors' and customers' goals. Ellman asserts that customers are not significantly affected by contract failure, an extreme position that he ends up contradicting (3). More interestingly, he affirms that in the mutual benefit case the crucial point is that of allowing customers to exert control in order to obtain a "special quality".

Regarding the role of the nondistribution constraint in the mutual benefit case, Ellman suggests that it prevents the formation of a class of investors that would push the organization to pursue their particular interests (1982, p. 1036). Finally, as to the relation with cooperatives, Ellman is in favour of maintaining an economic and juridical distinction between the two. His position rests on rather vague arguments, essentially based on the great diversity between, say, an agricultural marketing cooperative and a sporting club, the former being established to secure high prices to producers while the latter to secure high quality to consumers (see pp. 1048 - 1049).

A third view is expressed by Ben Ner (1986), who sees NPOs merely as a form of backward integration on the part of consumers. In order to identify their role, he discusses how consumer organizations can improve consumers' welfare in three situations of market failure due to quality problems: i) consumers who are less informed than producers; ii) a monopolist that both undersupplies quantity by exploiting its power over price and chooses an inefficient quality level; iii) a monopolist that produces an excludable public good and is unable to price-discriminate between heterogeneous consumers.

As to the relation between NPOs and consumer cooperatives, Ben Ner focuses on the absence of capital shares in the former, which removes the risk of power concentration in the hands of a few investors. On the other hand, he continues, the nondistribution constraint entails the loss of a degree of freedom as far as distribution to consumer-members is concerned, which can be an obstacle to allocative efficiency (the constraint might render the maximization of consumers' surplus incompatible with the maximization of the joint surplus of consumers and producer; see pp. 95 - 96).

In the following sections I assess the claims described here by providing an unified treatment of a large range of private organizations and of their specific functions.

III. The distribution of the organization's surplus: public benefit versus mutual benefit organizations.

In the following by the term organization I will refer to a fictitious person that is distinct from all the agents that are involved in its activity and, furthermore, does not include any of them. An exception is made for the directors, who are considered as the executors of the organization's will and are therefore identified with the organization itself (4). The considerations that follow are more relevant in the case of large, formal organizations, in which the various functions are played jointly by many agents.

If we exclude unlimited accumulation of wealth or resource dissipation as goals, any economic organization (NPOs included) pursues a distributive goal -- i. e. aims at devoting in some form or other its surplus to the benefit of a "beneficiary" group, that may be formed alternatively of members of functional categories such as buyers, consumers of nonexcludable goods, aid recipients, workers, sellers, and investors (5). Notice that, among the various interests of the beneficiaries, the organization is not usually aimed at promoting all of them, but only some -- often just one -- "privileged" interests (for instance in worker cooperatives security of employment and/or high salaries are usually privileged with respect to high remuneration of worker-members' capital shares). Statutes also specify the "dominant" group, that is awarded the ultimate decision making power over the organization. The dominant group may be formed of members of the categories already listed with reference to the beneficiary role; here, however, we must include also donors and trustees (i. e. directors not directly accountable to any of the other categories of agents involved with the organization). The dominant role may be assigned to only a fraction of the agents that perform a certain function in the organization (i. e. of a certain category); the same can happen as to the beneficiary role (6).

The nondistribution constraint, as defined above, exclusively refers to "explicit" forms of distribution of an organization's surplus (such as dividends or bonuses). However, distribution can occur also in "implicit" form, either overtly or covertly (think respectively of favourable prices for members and unduly generous non monetary benefits to managers).

Since implicit distribution occurs before the determination of the "accounting" surplus -- that is the object of explicit distributive decisions -- in order to discuss distributive decisions in a broad sense, one can refer to the "potential" surplus, that is the maximum surplus the organization as such might obtain in case in all its transactions, including those with the beneficiary group, it pursued its own interest (7). This would mean, for example, that the organization exploits its possible market power or informational advantage also in dealing with the beneficiary group or with and donors. It is the potential surplus that the organization is statutorily bound to devote to the beneficiary group, by either distributing it explicitly (if permitted) or surrendering it in the form of implicit distribution. Both forms of distribution can occur either immediately or with a delay, i. e. after accumulation. Although the potential surplus is a pre-distribution concept, its value is likely to depend on the assignment of both the dominant and the beneficiary role, to the extent that these affect the behaviour of transacting partners (or, equivalently, transaction costs). However, the concept can be made operational case by case by means of precise assumptions (an example is developed in Gui, 1988).

Implicit distribution is not a zero sum transfer. In fact, by modifying either the price or the quality of transactions with the beneficiaries, it affects their allocative decisions. Therefore, apart from administrative costs, the increase in the surplus of the beneficiary group due to implicit distribution can either be smaller or greater than the corresponding decrease in the organization's accounting surplus, depending on whether the resulting allocation is farther or nearer from that implied by the maximization of their joint surplus than was the previous allocation (8).

Organizations can be classified according to the economic functions played in the organization by the dominant group and by the beneficiary group, respectively, as in table 1 (9). The cases on the main diagonal can be designated as "mutual benefit", since the beneficiary and the dominant groups coincide: the firm is established to benefit the dominant group (via some privileged interest, not specified in the table). remaining cells can be labeled "public benefit" (10). They are characterized by noncoincidence between the dominant and the beneficiary group (11).

As the table shows, the only relevant "public benefit" cells belong to the last column, in which the dominant role is assigned either to trustees or to donors. The table immediately suggests that categories other than consumers can be the beneficiaries not only of mutual benefit organizations -- whether under the cooperative, the nonprofit or other legal formats -- but also of public benefit organizations. This is worth stressing since the attention of researchers in the economics of NPOs has been confined to organization intended to benefit either consumers or aid recipients.

IV. Why should a category be the beneficiary and why should the public or the mutual benefit option be preferred?

The first question to be asked is why a category should be established as the beneficiary of an organization acting as partner in a certain type of transaction. When should such an option be preferred by the members of the category (or by someone else on their behalf) to transacting with organizations having other beneficiary categories?

In order to simplify the question let us imagine that an organization having previously another beneficiary category is reorganized to benefit the category under consideration. Then let us look at the possible increases in welfare directly accruing to the latter (12). Several situations are conceivable, which are listed below. (In reality mixtures of these situations can be found).

1) Organizations having other beneficiary categories would exert ordinary market power to the detriment of the category under consideration (13). Similarly, where transacting entails a significant accumulation of specific assets on the part of the category's members, dealing with an organization with conflicting interests would expose the former to ex-post monopoly on the part of the latter in the form of opportunistic attempts to appropriate a disproportionate share of the quasi-rent of these assets (14).

2) The market for the "privileged" transaction is such that some members of the category would be either rationed or prevented from establishing long lasting contractual relationships. Then an organization aimed at providing these agents stable transaction opportunities represents from their point of view an appropriate response. (This applies particularly well to workers).

3) There is informational asymmetry as at least one important characteristic of the transaction (let us call it quality), with the category's members the less informed party. This informational asymmetry damages the members of the category in two ways. First, they may engage in transactions that they would refuse if better informed (i. e. whose quality is below the member's reservation level for the agreed price). Second, they may refuse mutually advantageous transactions because they do not trust the organization. (Notice that in case b the organization is also damaged by informational asymmetry (15)). This is a typical situation to which Hansmann applies his concept of "contract failure" (16).

4) There is asymmetrical information of the same type as in situation 3, but now the less informed party is the organization (to be more precise, the members of the category are more informed than outsiders not only about their own situation and behavior, but also about their colleague members' situations). The beneficiary position

gives the category's members an incentive to cooperate in both disclosing information regarding co-members and monitoring their actions so as to reduce transaction costs (17).

5) Adequate satisfaction of the preferences of the category's members as to the various characteristics of the transaction -- the same for all the members -- cannot be assured through market relationships, due to one or more of the following reasons: the number of different "bundles of characteristics" offered on the market is smaller than the number of characteristics, which prevents a market price for each characteristic from being implicitly determined (18); the true characteristics of transactions and their conformity with one's own preferences are known only by direct experience, while both writing complete contingent contracts and interrupting an ongoing contractual relationship entail high costs; new occurrences call for frequent readjustments of characteristics. Provided its members are sufficiently homogeneous, elimination of the conflict of interest between the organization and the category's members eases the maintenance of a stricter conformity of characteristics to preferences (conflict prevents the "voice" of beneficiaries having a more direct influence over the organization's choices; see Krashinsky, 1986, p. 123). This is the situation of consumers searching for a "special quality", as stressed by Ellman (19).

6) The transaction concerns an excludable public good. Allocative efficiency can be improved by better knowledge as to the willingness to pay of the category's members, that is the magnitude according to which price discrimination should be shaped. Elimination of interest conflicts between the category and the organization reduces the reluctance of individuals to reveal their demands, while horizontal monitoring by colleague beneficiaries can reinforce the effect. Price discrimination can even take the form of voluntary contributions above a base fee (20).

7) The category is constituted of consumers of a nonexcludable public good, so that recourse to individual action would lead to underprovision or even no provision at all. Provided some members of the category are ready to voluntarily contribute in order to cover the costs borne by an organization that offers to produce the good, they would not rely on an organization having another beneficiary

category, due to the prohibitively high costs of ascertaining whether their individual contributions are correctly used, rather than simply pocketed by that category (21).

8) The category is constituted of intended recipients of aid and therefore is the beneficiary by definition.

In situations 3, 4, 5 and 6 there is an efficiency case for the category's members being the beneficiaries. By coordinating their actions the category and the organization can obtain a greater surplus than by acting separately. In situation 8 the reason for assigning the beneficiary role is to redistribute surplus. In situation 7 both reasons hold. Similarly, in situations 1 and 2 both efficiency and redistribution come into play; however, in situation 2 redistribution may occur not only at the expense of an alternative beneficiary category, but also of other members of the same category that are not included in the beneficiary group. As already noticed, in all situations part of the gain can be lost when implicit distribution takes place.

Obviously, besides the above listed advantages of being the beneficiary, there are disadvantages that have to be taken into consideration. First of all, depriving another category of the beneficiary role may entail an efficiency loss. Secondly, attached to the beneficiary role is a greater risk to be borne by the category's members. In this regard note that individual beneficiaries can be sheltered from risk by using the accounting surplus as a buffer against variability in the potential surplus, but only up to a certain point. In the worst occurrencies the terms of their transactions with the organization necessarily deteriorate. However, to the extent that beneficiaries are free to refuse to transact with the organization without incurring significant penalties, an anusual share of risk ends by being borne by other categories (typically financiers); therefore, the cost of risk often takes the form of less favourable terms of transaction with such categories (22). Thirdly, since the dominant role will also have to be reassigned (either to the beneficiaries themselves or to trustees or donors) the cost of control over the organization changes (23), possibly in an adverse manner.

Naturally, beside the assignment of the beneficiary role to the category, there exist other responses to the market failures examined, both within the private sector (cost-plus contracts, professionalism, ..) and with the intervention of public authorities (see Hansmann, 1980, sect. VII; Krashinsky, 1986, pp. 116-117).

Linked to the previous question is a further question: once the category under exam is established as the beneficiary of the organization, who is going to play the dominant role and why? In other words, for what reasons should an organization established to serve a certain category adopt the public benefit or the mutual benefit form?

In general it can be said that control on the part of beneficiaries can assure a stricter conformity of the organization's activity to its established goals, due to both information and incentives considerations. Exceptions to this general statement are found in situation 8; the beneficiaries might not give priority, among their own interests, to those the donors have established as privileged (an obvious example is the tendency to devote to immediate consumption resources intended to improve education or health care). Secondly, control can be desirable per se, either on the part of the beneficiaries as an opportunity for personal and social advancement, or on the part of outside promoters as a strategy to make the members of the beneficiary group feel more responsible (24).

On the other hand, the mutual benefit solution can be hindered by the costs of collective action (especially in setting up the organization (25), but also during the subsequent operations). The elements that influence such costs include among others: group homogeneity and cohesion; number of members; transaction costs connected with distance and frequency or continuity of transactions; value of transactions of individual members; lack of cultural requirements on the part of beneficiaries (26).

This argument does not imply that when such costs are high the job of serving the interests of the category will be taken on by a public benefit organization, since this requires the willingness on the part of someone else to devote resources to the benefit of the category.

Furthermore, a public benefit governance of the organization also entails specific costs, stemming from lack of economic incentives to monitor performance (27).

In particular, in three of the situations listed above -- numbers 4, 5, and 6 -- in order to reap fully the advantage of being the beneficiaries the members of the category must accomplish some actions. This is more likely to occur if the category's members exert direct control over the organization, i. e. also play the dominant role. The importance of having "residual rights of control" (28) seems to be especially great in situation 4, while in situations 5 and 6 some forms of consultation might also be effective.

In situation 7, if the category is large and membership is not compulsory (29), control by beneficiaries necessarily involves only some of them, so that a neat mutual benefit response is nearly impossible. In some cases whether the organization has to be seen as public benefit or as mutual benefit is not obvious (30). On the contrary, neat public benefit responses are possible (an example are NPOs engaged in environmental activities). Also in situation 2 the mutual benefit solution seems fitter, due to both the conformity and the responsibility arguments.

In the case of aid recipients (situation 8), the arguments related to insufficient cultural requirements, lack of group cohesion, and possible differences between donors and beneficiaries in defining the privileged interest seem to reinforce each other so that nearly all charitable organizations are controlled either by donors or by trustees. Some exceptions are found especially in development aid, where one can find more or less informal organizations of recipients set up to allocate among themselves goods or money received from developed countries. Such an arrangement can be explained partly by the responsibility argument and partly by the costs of administering the allocation of aid among recipients on the part of a funding organization that is located thousands of kilometers apart and has insufficient knowlegde of local language, habits and so on.

As to situations, in which market power is the crucial issue, none of the arguments above is decisive in favour of either solution; the same can be said of situation 3, characterized by the most typical contract failure (31).

Possible reasons which might explain the dominance of the mutual benefit form in the former case and of the public benefit form in the latter are to be found elsewhere: in the participatory (rather than paternalistic) orientation of promoters of organizations intended to improve the economic situations of large interest groups (such as working class consumers); in the more explicit charitable nature of organizations serving privileged interests such as health care or education, and therefore in a greater role of philantropy in their formation and financing; in the fact that contract failure is usually associated with less homogeneous interests than market power, which renders control on the part of beneficiaries more costly; in that, in order for market power to significantly hurt an individual, the volume of his transactions in that market mus be large -- and therefore the costs of control relatively small -- while with contract failure this is not necessarily so; and so on.

V. Public interest organizations and the nondistribution constraint.

It is clear that the dedication of public benefit organizations to serve a privileged interest not pertaining to the dominant group has to be particularly protected. The prohibition to distribute explicitly the accounting surplus to non-beneficiary groups (such as managers, trustees, or employees) is therefore a necessary protection. However, it is not sufficient to ensure the compliance of actual distributive decisions with the statutory ends, due to the possibility that the potential surplus be either distributed in implicit form to non-beneficiaries or channelled to the service of other interests than either the founders established or the donors intend to support (32). This renders it advisable that the nondistribution constraint be reinforced by strict rules limiting the discretion of decision makers.

As stressed by Hansmann, asymmetrical information with the organization the more informed party is doubtless important in understanding the role of the nondistribution constraint in public benefit NPOs. First of all, as to beneficiaries, in situation 3 asymmetrical information is the reason for granting them a particular protection. Secondly, the nondistribution constraint also protects donors, this peculiar category whose interests by definition overlap with those of beneficiaries and that is nearly always affected by asymmetrical information.

In fact, the difference between these two situations is only one of degree, since uninformed beneficiaries resemble donors (see Hansmann, 1980, p. 872-73). An example is when the recipient is distinct from the buyer, so the latter remains partly uninformed even after the purchase (take for instance children's education or old parents' nursing care) (33). However, even when information asymmetry disappears ex-post consumers may be in a weak position; this is particularly true if the purchase is a crucial one (e.g. an esoteric treatment in a psychiatric clinic), and for any reason legal action does not represent an effective protection (this happens for instance if the characteristics of the purchase are not clearly specified in advance).

Informational asymmetry is not the only reason for imposing the nondistribution constraint in public benefit organizations; rather, I would agree with Hansmann's initial claim that the more general concept of contract failure is to be considered (see in particular conditions b and c in the definition presented in section II). In fact, even if those who deal with the organization (especially donors) are members, or anyhow are well-informed, the constraint still represents a guarantee to them. In fact, information apart, there are costs in writing and enforcing a detailed contract specifying the obligations of the organization. Therefore, the exclusion of distribution to the dominant group has some value even to a well informed member (the nondistribution constraint can be seen as a standard contract a la Posner; see Krashinsky, 1986, p. 116) (34).

As suggested in section IV, it may be that public benefit organizations represent a response to unfavourable prices, not quality problems. This seems to be, at least in part, the role played by NPOs providing housing at low prices (either to families or to students), or managing thrift shops, youth hostels, cheap food services and so on. In these cases prices contain an element of rent -- not necessarily accruing to the direct seller --, which the NPO intends to turn to consumers. It is to be stressed, however, that even in this case the rationale for the nondistribution constraint is contract failure. In fact, its effect is to render the organization more trustworthy to donors, not to beneficiaries (who do not need particular assurances, due to the nature of goods purchased). This assertion holds true even if no current donation is received, as is often the cases in the above examples. In fact, by definition, in public benefit organizations the donative element is never absent, since they owe their existence to an initial donation, at least of entrepreneurial resources, that the founders devote to a non self-regarding privileged interest, both in the present and in the future.

An important question that remains to be answered is why very few examples can be found in which the interests of beneficiary categories different from consumers and aid recipients are promoted in the public benefit mode, i. e. by a nondistribution constraint rather than by active participation. One reason is that both sellers and workers are usually much more specialized than consumers in their transactions qua sellers or workers. Thus, transactions with an organization created to forward their interests of sellers or workers would account for a significant share of all their transactions. Furthermore the relationship with such organization would be either a continuous or a repeated one. All this reduces the costs (in relation to the value of transactions or even in absolute terms) of beneficiaries starting and controlling the organization. A second reason is that these functions in most cases define the professional status of the agents themselves, which on the one hand provides a further stimulus to playing an active role and on the other exposes a non participatory response to the charge of paternalism.

The second reason suggested above helps us to explain why organizations aimed at benefitting workers often adopt, at least formally, a participatory statute even in cases in which the beneficiaries play no role in starting them and a minor one in controlling them. This is the case, for example, of worker cooperatives formed in US during the Great Depression to engage unemployed labourers in public works. The same can be said of worker cooperatives that exclude any remuneration of capital shares and limit wages to prevailing levels, in order to devote their potential surplus to providing a job for handicapped worker-members. A notable exception is represented by those US companies in which Employee Stock Ownership Plans (ESOPs) own the majority of shares (even 100% in some cases), but the control is in the hands of trustees (35).

Another exception is provided by some voluntary benefit organizations aimed at benefitting sellers located in particularly disadvantaged communities. A noticeable example is the German network of "third world shops" that markets handicraft or agricultural products directly shipped from selected poor areas (36).

So far I have discussed how can the nondistribution constraint, that characterizes the nonprofit form, serve the statutory goals of a public benefit organization. However, it is not surprising that it can also serve other, less noble goals. In particular, the absence of residual claims frees directors and managers from the control of dominant shareholders or from the threat of hostile takeovers (see Fama and Jensen, 1983A, p. 319; Hansmann 1985A, sect. 3.6). Furthermore, tax advantages of NPOs can allow profit-seeking entrepreneurs to appropriate (covertly) more surplus than under the legal format of a business corporation (see James, 1987, p. 403). Notice that, although the public benefit form is more apt for pursuing such aims, the mutual benefit form lends itselt equally well to such exploitation if member participation is known to be ineffective.

VI. Constraints to distribution in mutual benefit organizations.

According to table 1, mutual benefit organizations also include those whose members are investors (e. g. joint stock companies). These are characterized by the fact that the privileged interest is a high return on the wealth permanently committed to the organization by its members. Since the title to share in the surplus of the organization derives from a once and for all contribution, no further transaction between the member and the organization is required. Each share is then an unconditional claim to the flow of future residual income and therefore lends itself to "capitalization". In all other mutual benefit typologies, instead, in order to enjoy a fraction of the organization's surplus, members have to repeatedly perform some activities, such as selling or buying from the organization goods or services, or even using the facilities of a club. This on the one hand leads to the imposition of constraints to the saleability of membership rights (colleague members are not indifferent as to whom they have to deal with), and on the other conditions the appropriation of the future surplus by the individual member. Capitalization is therefore hindered. In this sense joint stock companies can be called "capitalist" (37), as opposed to "noncapitalist" organizations such as NPOs and cooperatives (38).

Notice that in cooperatives, that account for a significant share of mutual benefit typologies, membership -- and therefore decision-making power -- is formally attached to the ownership of capital shares, while the intended beneficiaries are, say, member-suppliers of milk to be processed. However, a further condition for membership in the case under exam is to be a milk producer. Moreover, the remuneration of capital shares is usually limited and their transferability is restricted. Thus, both the dominant and the beneficiary roles are in fact assigned to milk suppliers.

For what has been said above in joint stock companies by definition no overt implicit channel of distribution to members should exist. Thus the imposition of constraints to distribution conflicts with the mutual benefit aim. In fact, when there are constraints, such as in limited dividend companies, they are not intended to favour the beneficiaries, but to protect other categories (typically customers).

As regards "non-capitalistic" types of mutual benefit organizations in general, I maintain that the role of a strict nondistribution constraint, if any, is less important than in public benefit organizations (where it has been shown to be necessary -- although not sufficient -- to enforce the desired distribution pattern). Instead, it may be unnecessarily restrictive and therefore detrimental to the organization's activity.

In fact, in mutual benefit organizations, even in the absence of the nondistribution constraint, the beneficiary group, by also constituting the dominant group, has the power to ensure that an explicit distribution of the potential surplus to the benefit of other groups does not occur. Furthermore, as regards distribution to their own benefit, it is not blocked by the nondistribution constraint: an implicit distribution of the organization's surplus to the benefit of members is still possible, even overtly, as is shown for example by cooperatives, in which it represents the major channel by which the organization benefits its members.

The approach presented in this article can only suggest some noncompelling reasons for imposing a nondistribution constraint in the mutual benefit case. They come from the recognition that the members of the dominant group usually have several distinct interests in the organization's activity, while in general the organization is not established to foster all of them. Thus protection is needed against some members pressing the organization to pursuing preferentially a different, conflicting interest from that statutorily established as privileged.

First of all, the nondistribution constraint blocks distribution to investors. However, it seems too drastic a response. The cooperative practice (especially in Europe) is very eloquent with this regard. In many cases the problem of having extraneous investors trying to force the organization to pursue their own interest has been solved by pressing the members -- primarily involved as customers, suppliers or workers, depending on the cases -- to provide themselves all or most of the equity capital. If such a solution prevents outsiders taking upon the dominant role, a dangerous dichotomy of goals among those controlling the organization can arise whenever some members' investment is significant, while some others' is not. However, in order to avoid that the former direct the firm to protect in the first place their interests as investors, setting a limit to the remuneration of capital shares is a sufficient guarantee (such a practice is suggested by the International Cooperative Alliance; similarly, nonvoting securities with variable but limited yield, called "subventions", are explicitly admitted in NPO statutes of Pennsylvania and New York States, as reported by Hansmann, 1981A, p. 564). In fact, especially if one considers the event of dissolution, the right of recouping at some future time the capital privided to finance the organization, seems more important to possible contributors than the remuneration of shares (39).

Secondly, the nondistribution constraints excludes any monetary distribution to members according to their share in the volume of "privileged" transactions. In some cases such exclusion may be functional to the aims of the organization. For example, when the primary interest of member-customers is in keeping the quality of their purchases as high as possible, the conflicting interest to keep the effective price as low as possible (in particular through profit distribution according to "patronage") has to be kept under control (see Hansmann, 1980, p.889-90). Notice, however, that the possibility of members, by means of the internal pricing policy, neutralizing such effects of the nondistribution constraint, or, viceversa, obtaining the same results in the absence of the constraint itself, limits the importance of such arguments.

It is to be noticed that a constraint that blocks distribution according to "patronage" may be non binding, since in many instances monetary distribution is uninteresting. For instance, if the volume of transactions with the organization is uniformly distributed among members and membership is stable, granting members more favorable prices in the following year is largely equivalent to an immediate distribution of the accounting surplus, and causes smaller administrative costs. Similarly, if some self-financing is required, reinvesting the surplus is likely to reduce transaction costs with respect to distributing it and, subsequently, collecting capital contributions from members themselves.

Another argument against distribution, that arises when nonmembers as well as members deal with the organization, concerns the fact that members may distribute among themselves -- in the form of either price rebates or dividends -- an accounting surplus that is partly obtained in transacting with the former. Such a practice would be questionable in organizations that in a sense are supposed to foster the interest of an entire category (Hansmann, 1981A, pp 559 - 560). However, also in this case a less drastic regulation is sufficient for the purpose (such as the prohibition to distribute the share of profits that corresponds to transactions with nonmembers, as discussed in the debate on the new Italian cooperative law).

VII. Summary

Focusing on the interest that is established as privileged and on the dominant or passive position of the designed beneficiary group, as I do in this paper, helps in clarifying the economic functions of the various "non-capitalistic" private organization and the rationale for submitting them to limitations as to surplus distribution, as happens in NPOs and, to a lesser extent, also in cooperatives.

Several implications arise from this effort of clarification. First of all, imposing the nondistribution constraint, i. e. adopting the nonprofit form, is only important in public benefit organizations, while in mutual benefit organization it may even be an unnecessary hindrance. Therefore, no substantial distinction in the functions played by cooperatives and mutual benefit NPOs can be found. (In particular cases it may be advisable that the statutes exclude any monetary distribution, but this is an internal affair). Second, the nondistribution constraint is generally motivated by asymmetrical information on the part of both donors and beneficiaries; however, it can also serve well-informed donors when enforceability is costly. Third, NPOs can also represent a response to unfavourable prices and, conversely, cooperatives can also be a response to quality problems. Fourth, the beneficiaries of a public benefit organizations are not necessarily consumers or aid recipients, but may also be workers or sellers. Last, joint stock companies can be characterized as "capitalist" with respect to both NPOs and cooperatives since their beneficiaries are not required to perform any repeated transaction with the organization, which eases the capitalization of the claims to its future surplus.

NOTES

(1) See James and Rose-Ackerman (1986, p. 4); Hansmann, 1980, p.838). An alternative definition, typical of the German tradition, refers instead to the absence of "... a continous productive or speculative activity..." (Verrucoli, 1985, p. 8-9).

(2) He proposes the labels: "donative" and "commercial" to refer to the main source of income; "entrepreneurial" and, respectively, "mutual" to refer to control. In this context "mutual" stands roughly for "participatory", clearly a different meaning from "mutual benefit".

(3) Such a position implies that non member-controlled NPOs that are financed by the sale of their services should remain outside the analysis (they are neither "donative" nor "mutual benefit"), despite the fact that they represent the majority of US NPOs (think of hospitals, schools, personal services, ..). However, in dealing with such organizations Ellman inadvertently uses Hansmann's argument that customers feel safer if they know that those managing the organization cannot profiteer. In fact, on p. 1022 he tries to include in his "donative" category a larger group of organizations than this label, as opposed to "commercial", would suggest, by saying that the voluntary submission to the nondistribution constraint can convey a message of altruism to potential customers.

(4) For the sake of simplicity the directors' role of suppliers of managerial or even monitoring services is disregarded. However it could be considered separately.

(5) For convenience, depositors will be treated as buyers (of financial assets) and borrowers as sellers.

(6) Examples are voting and nonvoting shares in joint stock companies, with the latter only awarded the beneficiary role; member (i. e. dominant) and nonmembers donors in charitable organizations; member or nonmember customers in consumers cooperatives, with the latter excluded from both roles; subsidized (i.e. beneficiary, typically the students) and unsubsidized customers in university cafeterias.

(7) A similar concept is used in Ben Ner and Neuberger

(1981).

(8) For example if beneficiaries are consumers and the potential surplus is obtained at a price exceeding marginal cost, at least up to a certain point implicit distribution leads to Pareto-superior allocations (this is the case in Hansmann 1981B, where he discusses the effects of donations when, due to high fixed costs, average costs are significantly higher than marginal costs, as it happens with performing arts; a similar configuration of costs is assumed also by Holtmann, 1985, to present a theory of NPOs based on uncertain demand). The opposite occurs in case, in order to distribute monopoly profits, prices are set below marginal costs. In fact, explicit distribution also has allocative effects whenever it is apportioned according to the volume of some type of transaction with members, and nonmembers are excluded from that type of transaction. This is a central theme in the economics literature on labour-managed firms, where it is known as the "Ward-Vanek effect" (see the recent reviews in: Bartlett and Uvalic, 1986, who also supply a rich bibliography; and Bonin and Putterman, 1987).

(9) The classification presented in table 1 differs in several respects from that proposed by Hansmann (1980). Apart from restricting his analysis to organizations serving consumers or aid recipients, he focuses on the single transaction that commits money to the organization (whether a purchase or a donation) rather than with the destination of the surplus connected with all the organization's transactions; in the case of donations this leads him to discuss the protection of donors' will (1980, p. 845) rather than the other side of the coin, i. e. the promotion of beneficiaries' interest.

(10) The distinction between mutual benefit and public beenfit NPOS is adopted in the New California Nonprofit Statute (see Hansmann, 1981A, pp 583 - 584) and is analogous to the charitable-noncharitable distinction (see Simon, 1987, p. 69).

(11) The motivation of nonprofit entrepreneurs, who, apart from the possibilities of abuses (disguised profit distribution), cannot expect any monetary gain from the organization they set up, represents a puzzling question for economists and requires a broader understanding of the forces driving economic actions (see for example Young,

1983, and James, 1986). I merely observe that, not only in public benefit NPOs, but also in noncapitalistic mutual benefit organizations, the entrepreneurial role is usually played de facto by a small group, while the participation in the privileged interest is highly dispersed among the beneficiary group. Thus, the drive to entrepreneurship cannot be explained by the entrepreneurs' participation in the privileged interest. Alternative explanations are needed, based on the desire to realize something valuable, the search for prestige or personal satisfaction, etc..

(12) I am thus disregarding the (indirect) effects on the category that are due to modifications in the equilibrium of the market in question (these can be caused by both the different behavior of an organization pursuing different goals and by the possible modification in the number of competing organizations).

(13) The existence of an oligopolistic retail market is the traditional motivation for forming consumer cooperatives. See also Ben Ner's (1987) discussion of the advantage of forming worker cooperatives in face of an oligopsonistic local labour market. In fact, by forming an organization to their own benefit, the members of the category may also take advantage of any market power the organization is in a position to exert toward other categories (i.e. an attack, not a defense strategy)

(14) This is the rationale for vertical integration suggested by Klein, Crawford and Alchian (1978), who see mutual ownership of country clubs as a protection of a specific quasi-rent (in fact Hanmann's reference to "monopoly" in the case of clubs should be intended as ex-post monopoly). The three authors also refer to specific human capital as an asset that needs particular protection; this argument is developed by Alchian and Woodward, who suggest that in some cases this is a good reason for the firm being managed to the benefit of workers (and controlled by them). Avoiding post-contractual exploitation on the part of the organization is indeed an important reason for investors controlling organizations.

(15) It is well known that informational asymmetries may prevent some markets from operating, despite the potential mutual advantage of buyers and sellers (see Akerlof, 1970).

(16) Among other examples (some of whom have already been mentioned), Hansmann (1987B) suggests that mutual savings banks, that are run by trustees to the benefit of depositors, have been formed for precisely this reason, i. e. to protect uninformed depositors from bankers engaging in exceedingly risky ventures (risk being the relevant "quality"). He obtains similar conclusions as to life insurance mutuals. This argument too applies to investors as well.

(17) An example is provided by property and liability insurance mutuals and saving and credit cooperatives. Here too risk is the relevant "quality" characteristic (notice that both adverse selection and moral hazard come into play). Hansmann notices that the best response to this type of market failure would be, if conceivable, that the organization "owned" the insured or the borrowers, rather than the other way round, which has to be seen as a second best option (1987B; see also 1985A).

(18) Dreze (1976) uses this result in search for a rationale for worker-managed firms.

(19) Ellman refers in particular to parent-controlled day care centers (1982, p. 1035). Hansmann, instead, never considers situations in which quality is inherently a multidimensional magnitude (in situations 3 and 4 quality could be simply considered as a scalar), notwithstanding that they fit into his definition of contract failure. Notice that situation 5 does not require opportunism on the part of the organization, that might even be indifferent to the choice of characteristics (as where the organization is the producer and all choices entail the same cost). Obviously, if there is room for opportunism the market solution is even less satisfactory. Ben Ner (1987, pp. 440 - 441) applies this argument to the provision of workplace characteristics in examining the reason for the formation of worker cooperatives.

(20) See Hansmann (1981B) and Ben Ner (1986, case iii, as mentioned in section II), who make particular reference to the performing arts. Also in Ben Ner's case ii (indeed the least convincing), in order to improve the choice of quality, consumer organizations have to rely on demand revelation on the part of their members.

(21) This "marginal impact monitoring" problem (see Ellman, 1982, p. 1009, who first uses this expression) applies for example to donor-supported educational broadcasting. Donors are concerned that their contribution may not be used to improve the quantity or the quality of programs.

(22) See the discussion in Gui (1985) with reference to worker cooperatives.

(23) Both the costs entailed by the degree of oversight exercised and by the remaining managerial slack have to be included (see Hansmann, 1987B, p. 17-21).

(24) For a discussion of participation in voluntary organizations in the African context see Anheier (1987). See also Hansmann, 1980, p. 890-91.

(25) The inability of the category's members to start a successful initiative does not necessarily preclude the mutual benefit solution. In fact, the peculiar difficulties of the early stages can be overcome by (or with the aid of) outside entities, such as public agencies, philantropists, cooperative associations and so on. The pattern that sees outside support leaving room to self-governance is quite common in the history of non-capitalistic organizations. In a sense what is required for the viability of the mutual benefit form is the ability to successfully govern the organization once started. It can even result that in this second phase active member participation is not so important for continuation (this seems to be the case of the above mentioned life insurance mutuals; see Hansmann, 1985A).

(26) Some hints at this issue can be found in Hansmann (1987B, 1989), Krashinsky (1987, p. 123), Ben Ner (1986, p. 108); see also as a general reference Olson (1965, p. 43).

(27) This is the theme repeatedly raised by the "property rights school" (see Steinberg, 1987, pp. 127-130, for an overview of their contributions).

(28) This notion is connected by Hart (1988) to the problem of ownership; however, it remains useful even when there is no owner, as in NPOs.

(29) There exist examples of private non-voluntary mutual benefit organizations, such as those caring for the

maintenance of agricultural infrastructures (e. g. Italian "consorzi obbligatori"). A similar situation occurs in condominiums.

(30) One might say that it depends on whether non members are considered as intended or unintended beneficiaries. See the debate between Hansmann (1985) and Ellman (1982) on whether members' contributions to business associations have to be seen as purchases or as donations. In such cases the two protecting mechanisms can fruitfully supplement each other.

(31) As mentioned above, Hansmann sees a correspondence between market power and cooperatives on the one hand, and contract failure and NPOs on the other. In a somewhat ambiguous passage Hansmann seems to consider control as an inferior solution to the enforcement of a nondistribution constraint as to the protection of beneficiaries' interests (1981A, p. 597). In fact, with reference to cooperatives, he says that they are suitable for situations, such as those involving natural monopoly, in which simple contractual devices do not adequately protect the beneficiary group, "but in which direct patron control over the organization is sufficient for this purpose". The nonprofit corporation, he continues, is convenient "for situations -- such as those characterized by contract failure -- in which neither simple contractual devices nor direct control provide adequate and workable means by which patrons can police producers..". I do not agree with the view that seems to be implicit in these sentences, namely that control on the part of the beneficiaries is not an adequate response to contract failure. Indeed, in many cases the costs of such control are prohibitively high. However, this does not depend on the type of market failure it should remedy (whether market power or contract failure). See also Hansmann, 1985 A.

(32) This is one of the possible effects of "cross-subsidization". See on this issue James (1986, p. 155), who is very concerned about the effective trustworthiness of NPOs, due to such possibility.

(33) It is surprising that Ellman does not see the similarity between donors and uninformed buyers, since "marginal impact monitoring" problems also arise in the second instance. In the example of the nursing care of an elderly relative, the relevant marginal impact of the fee

paid is not only his or her enrolment by the caring organization, but also obtaining a treatment of higher quality.

(34) Consider for instance a public benefit organization controlled by those supporting it, say in the form of membership fees and voluntary work, a situation that is typical of small local charities or cultural organizations. In this case the main reason for imposing a formal nondistribution constraint is the fear that the majority of co-members might change their minds as to the goals to be pursued, with respect to the founding agreement. For this reason the nondistribution constraint is likely to be supplemented by other restrictions in the organization's charter as to the destination of its resources. Only to the extent to which the organization also relies on support by less informed contributors, can informational asymmetry also be a reason for imposing the nondistribution constraint.

(35) Hansmann, 1989, interprets this seemingly paradoxical situation in which workers bear the risk without having control as due, on the one hand, to the high cost of collective decision-making by large nonhomogeneous constituencies, and, on the other, to the fact that in such a way control is still not in the hands of a potentially adversarial category.

(36) I owe this example to a conversation with Renate Pollvogt and Manfred Glagow.

(37) In the spirit of Williamson (1985) these types of organizations might be viewed instead as particular institutions of capitalist systems. Alchian and Woodward are particularly explicit in adopting this view (they go as far as to include even the family; 1988, p.76)). I do not think that this is useful, since such institutions are far from being typical of capitalism (as to NPOs in socialist countries see for example Neuberger, 1982).

(38) It has to be said that the statutes of some cooperatives, especially in the US, make them not much different from joint stock companies.

(39) Notice that in many US states the nonprofit law admits

distribution of net assets at dissolution, which is sensible, for instance, in the case of clubs. However, it is in conflict with the very idea of NPO. In fact, a coherent nondistribution constraint should imply that the organization's asset be devolved to organizations having similar purposes. Otherwise, its effect is simply to delay distribution (see Hansmann, 1981A, p. 593).

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